Criticism of the EU Supply Chain Protection Act
An economic contribution to the discussion

Johannes Stephan,
TU Bergakademie Freiberg

On May 24, 2024, the Council of Ministers of the European Union adopted the Directive on corporate sustainability due diligence (the European Supply Chain Protection Act or *Lieferkettenschutzgesetz*); the directive will now be adapted into national law over the next few years and then implemented.

In terms of content, it is essentially about the protection of human rights and environmental protection, which is to be ensured throughout the entire supply chain under the legal responsibility of European buyers. However, it only applies to very large companies.

In terms of environmental protection, the directive goes beyond its German counterpart, the *Lieferkettenschutzgesetz*. It falls short of the German Supply Chain Protection Act in that it only applies to very large companies.

In the USA, there are similar regulations that shift responsibility for external conduct to the domestic market. For example, the Foreign Corrupt Practices Act requires domestic companies to comply with due diligence obligations when conducting business abroad in order to prevent bribery and corruption.

Such a shift of responsibility to the domestic market is controversial. I would like to take a brief look at some of the main points of criticism from an economic perspective.

1. Is it wrong to shift responsibility for corporate behaviour abroad to the domestic market?

   (Almost) everyone agrees on the goal. There is no consensus on the choice of instrument to hold our commercial customers and investors in other countries accountable at home. That would be surprising, as there are other instruments. However, I come to the conclusion that the instrument has been well chosen.

   One possible alternative, leaving responsibility in the country of the supplier, looks logical at first glance. However, the institutional conditions in many of the underdeveloped supplier countries are nowhere near strong enough to enforce the protection of human rights and the environment. In the very first instance, this increases costs, hence the resistance. The advantages of a solution that can be enforced in developed countries become particularly clear where the suppliers are subsidiaries of local investors.

   An instrument that is institutionalized via the UN, WTO or Washington institutions would also be interesting. However, such supranational instruments can hardly be more effective: (i) The solutions that can be agreed at such a broad level are typically a minimum consensus that is insufficient for the objective. (ii) These non-governmental institutions themselves have limited enforcement power; ultimately, the states themselves are sovereign. Nevertheless, the advantage of membership in such institutions is the power to enforce common rules.

   Another alternative is to allow injured municipalities and individuals to sue the buyers of their companies in the buyer country. This solution has already been chosen for foreign investments. For example, in January 2021, an appeals court in The Hague imposed a "duty of care" on Royal Dutch Shell vis-à-vis its Nigerian subsidiary. This has already led to successful lawsuits and can serve as a precedent for further cases. It remains to be seen whether aggrieved municipalities and individuals abroad have sufficient chances of enforcement.

2. Will the law become a bureaucratic monster?

   I'm not an expert on this criterion; it's a matter for lawyers and administrative experts to resolve. But it is clear that all those affected probably have legitimate concerns about further bureaucratization: How can a prohibition system with penalties be implemented other than with an extensive burden of proof?

3. Will the law increase legal uncertainty?

   The implementation of the law must attempt to minimize legal uncertainty, which is a difficult requirement given the global reach with great heterogeneity of the conditions of economic activity abroad. International engagement in global supply chains will necessarily become more uncertain as a result of the law: Companies must ensure the required behaviour in foreign countries with foreign legal sovereignty and culture.

   From an economic perspective, the additional risk for internationalization has an important implication: the control of supply chain partners that now becomes necessary increases the costs of using the market (so-called transaction costs) compared to integration within the vertical value chain. Although this also tends to lead to an internalization of these transaction costs domestically, the internalization pressure is much stronger compared to a foreign country where it is even more difficult to control the market. It is to be expected that previously loose networks of global value chains of European manufacturers will become increasingly integrated by seeking greater control over economic behaviour with regard to human rights and environmental protection through ownership shares. This will lead to a greater concentration of market power of increasingly internationally active companies - or, to put it positively, to greater international competitiveness of these European companies.

   It is also conceivable that companies could decide to source more nationally or at least within the richer economies that are easier to control, i.e. to replace imports with production closer to home. Such a location decision is hardly to be expected in view of the profit opportunities offered by a global network of particularly large and usually already highly internationalized companies. Finally, there are occasional warnings from industry that the Supply Chain Protection Act could lead to production being relocated abroad. However, this warning would only be valid if foreign importers were not subject to the Supply Chain Protection Act and other regulations that prevent the import and sale of products from foreign companies if their products violate human rights or damage the environment. The implementation of the EU directive will therefore have to include the regulation of foreign competitors, including those that arise through relocation outside the EU.

Overall, it can be stated that the criticism from industry is certainly justified, especially where increased bureaucracy increases costs. However, there are good reasons for shifting responsibility to the home country and the assertion that increasing legal uncertainty is a threat to business locations is by no means valid, at least not for European economies.

If the world wants to enforce human rights and environmental protection, it must hold industry to account - fulfilling obligations will always incur costs. It would be fair if such laws applied equally to companies in all countries. However, international competitive conditions are not significantly determined by such a supply chain protection law, as the example of the Foreign Corrupt Practices Act in the USA, for which there is no European equivalent, shows. The European directive and the German Supply Chain Protection Act, which preceded it, can also serve as a model for other countries. This can be seen as an inspiration for supranational institutions.